United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

74-1406

No. 74-1406

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

NATHAN CUMMINGS AND JOANNE T. CUMMINGS,

Appellees

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant

ON APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLANT

SCOTT P. CRAMPTON,
Assistant Attorney General,

MEYER ROTHWACKS,
RICHARD W. PERKINS,
LOUIS A. BRADBURY,
Attorneys,
Tax Division,
Department of Justice,
Washington, D.C. 20530.

TABLE OF CONTENTS

CITATIONS

Cases:

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 74-1406

NATHAN CUMMINGS AND JOANNE T. CUMMINGS,

Appellees

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant

ON APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLANT

STATEMENT OF THE ISSUE PRESENTED

Whether taxpayer's payments made under Section 16(b) of the Securities Exchange Act of 1934, which requires a corporate insider to surrender to the issuing corporation a portion of the sales proceeds from short swing trading in the corporation's stock, must be treated as a long-term capital loss since the payments are effectively an adjustment with respect to the earlier sale which had been taxed at favorable long-term capital gains rates.

STATEMENT OF THE CASE

This is a federal income tax case involving a deficiency in the amount of $45,790.18 for taxable year 1962. The Tax Court (Honorable C. Simpson) filed findings of fact, an opinion,

and a decision, on April 23, 1973, holding that the payments here in issue, made pursuant to Section 16(b) of the Securities Exchange Act of 1934, constituted an ordinary and necessary business expense under Section 162(a) of the Internal Revenue Code of 1954. (R. 74-85.)[1] On July 5, 1973, the Commissioner filed a motion for reconsideration and revision of that opinion, and a motion to vacate that decision, which the Tax Court granted on July 9, 1973. (R. 86-92.) On October 2, 1973, the Tax Court reaffirmed its prior decision[2], although six judges dissented. The decision was entered on October 2, 1973. The Commissioner filed a timely notice of appeal on December 28, 1973. (R. 93, 105.) Jurisdiction is conferred upon this court by Section 7482 of the Internal Revenue Code of 1954.

The relevant facts as stipulated (R. 4-9) and as found by the Tax Court (R. 75-80) are as follows:

Since 1940 taxpayer[3], Nathan Cummings has been principally involved with Consolidated Foods Corporation (CFC), which he founded, as its board chairman and chief executive officer. Prior to, during and since 1962, taxpayer has also been

1/ "R." references are to the separately bound record appendix.

2/ The Tax Court decisions are reported at 60 T.C. 91 (1973) and 61 T.C. 1 (1973).

3/ Joanne T. Cummings is a party hereto solely because a joint income tax return was filed.

a director and shareholder of many corporations including Rival Packing Corporation, Associated Products, Inc., Bon Ami Corporation, City Stores Company, and General Dynamics Corporation. (R. 5-6.)

During the years 1959 through 1963, taxpayer Nathan Cummings had been a director of Metro Goldwyn Mayer, Inc. (MGM). Taxpayer became a director of MGM in 1959 after purchasing 51,500 shares of MGM stock at a minimum total cost of $1,030,000. At that time MGM was having problems and taxpayer was informed that if he would buy the shares and become a director, three other directors involved in MGM's controversy would resign. Taxpayer's purpose in becoming a director was to make a profit by improving MGM's performance. In his capacity as a director, taxpayer participated actively in MGM's corporate affairs. (R. 6, 42, 76-77.)

On April 17, 1961, taxpayer sold 3,400 shares of MGM stock for a total of $227,648.28 and reported the realized gain, along with the gain on similar sales of MGM stock in March, 1961, as a long-term capital gain on his tax return for 1961. On various dates from September 18, through October 2, 1961, taxpayer purchased a total of 3,000 shares of MGM stock for a total of $146,960.89. Throughout this period taxpayer continued to be a director of MGM. (R. 6, 77.)

After submitting its preliminary proxy solicitation material, which had been prepated for its annual shareholders meeting to be held on February 23, 1962, MGM received a letter on January 16, 1962, from the Division of Corporation Finance of the Securities and Exchange Commission (SEC). (R. 10.) The letter noted that taxpayer had purchased 3,000 shares of MGM stock during September and October of 1961, after having sold a similar amount within the previous six months, and that if he realized--

> any material profits from these transactions which under Section 16(b) of the Securities Exchange Act of 1934 inure to and are recoverable by the issuer, the pertinent facts with respect to these transactions should be disclosed in the proxy statement. 4/

The so-called insider's profit herein amounted to $53,870.81. (R. 7, 10, 78.)

Upon receipt of the SEC letter, the secretary of MGM informed taxpayer of its contents. Taxpayer made immediate payment to MGM of the total amount. The Tax Court credited (R. 79) taxpayer's testimony (R. 45-46) that he made the payment at that time in order not to delay the issuance of MGM's proxy statement and to avoid the impact which disclosure of his potential Section 16(b) liability might have on his business reputation, and also credited (R. 78-79) taxpayer's testimony (R. 79) that the Section 16(b) liability had resulted solely from inadvertence.

4/ Section 16(b) of the Securities Exchange Act of 1934 prohibits an "insider", including a corporate director, from buying and selling or selling and buying within a six-month period, the stock of a corporatin in which he is an insider. If such transactions occur, and result in a profit, the corporation

Taxpayer subsequently wrote to MGM on February 1, 1962, requesting a refund of this amount on the basis that such a payment may not be necessary if the violation was inadvertent. (R. 79.) MGM referred the matter to independent counsel for an opinion, who recommended that MGM not make the refund. MGM made no refund. (R. 7-8, 11, 23-25, 78-79.)

On his 1962 tax return taxpayer deducted this payment as an ordinary loss, and the Commissioner determined it was a long-term capital loss. (R. 8-9, 80.) The Tax Court originally held (R. 83-85) that being a director was part of the trade or business of the taxpayer and also held that the payment in question constituted an ordinary and necessary business expense incurred to protect his business reputation. After reconsideration, the Tax Court affirmed (R. 93-100) (six judges dissenting) its prior decision, based upon its holding that taxpayer made the payment to MGM here in issue for business reasons and for reasons growing out of his responsibility as a director of MGM (R. 98). Accordingly, it denied the Commissioner's motion for reconsideration and revision of the opinion. (R. 100.)

4/ (continued)
should either be paid the profit or show the profit on its annual report as a debt owed to it. Securities Exchange Act of 1934, c. 404, Sec. 16, 48 Stat. 881 (15 U.S.C. § 78p).

SUMMARY OF ARGUMENT

This case is the third of its type to come before a Court of Appeals involving the tax characterization of a payment stemming from the insider profits provision of Section 16(b) of the Securities and Exchange Act of 1934 arising from a transaction in which the taxpayer realized long-term capital gain. In the prior cases, the Sixth and Seventh Circuits each have reversed the Tax Court and held that such payments constitute capital losses for federal tax purposes, under the application of the tax benefit principles enunciated in Arrowsmith v. Commissioner, 344 U.S. 6 (1952) and United States v. Skelly Oil Co., 394 U.S. 698 (1969). The Tax Court, refusing to follow the Sixth (Mitchell v. Commissioner, 428 F. 2d 259 (1970)) and Seventh (Anderson v. Commissioner, 480 F. 2d 1304 (1973)) Circuits, has again viewed such payments as qualifying for treatment as ordinary and necessary business expense based upon a factual determination that the payments were made in connection with a trade or business of the taxpayer, and to protect taxpayer's business reputation. Under the Tax Court's view, these findings are sufficient to negate any integral relationship between the payment and the prior stock sale from which the capital gain arose. We believe the Tax Court's legal analysis to be incorrect.

In Arrowsmith and Skelley Oil, the Supreme Court held that a payment which had its genesis in a prior income transaction and represented an adjustment offsetting that income must be

characterized for tax deduction purposes in the same manner as the prior income. In Arrowsmith, payments received by a corporate transferee were considered as capital losses offsetting the prior capital gain received by the transferee on the corporate liquidation. In both Mitchell and Anderson, the Sixth and Seventh Circuits characterized payments arising under Section 16(b) of the Securities and Exchange Act of 1934, as merely a repayment of income which taxpayer had received on the stock sale, i.e., as an offsetting adjustment to the profits made on the prior stock sales. Both courts further held that a taxpayer who had received preferential (capital gains) tax treatment on the proceeds of the stock sales was only entitled to similar (capital loss) treatment on the disgorgement of such gain. Herein taxpayer reported his stock sale profits as capital gains, but he now seeks to deduct as an ordinary business expense, the amounts paid over to MGM. The Arrowsmith tax benefit principle must be applied to prevent taxpayer from receiving a tax benefit from the insider stock transactions.

The Tax Court here, as in prior cases involving Section 16(b) payments, viewed the original sale profits as not integrally related to the repayments under Section 16(b). Such an analysis has consistently been rejected as artifical and contrary to the nature of the Section 16(b) payment. The Section 16(b) liability is automatically triggered when an insider realizes profit on a sale and purchase or purchase and sale, within six

months, on a security of a corporation of which he is an insider. Taxpayer's sale or purchase of MGM stock (while he was an insider) was within the proscribed six month period and thus triggered the application of Section 16(b).

The Tax Court's continuing efforts to attach controlling importance to findings as to the capacity in which taxpayers payments which stem from Section 16(b) likewise must fail. Section 16(b) applies only to insider shareholders and, that statutes requires disgorgement of profits realized from stock transactions falling within its terms, regardless of the nature or other circumstances which prompted the insider stock transactions. Accordingly, it is of no significance that a taxpayer might desire to promptly make the payments required by Section 16(b), to avoid any harm to his business reputation, or to assist in accomplishing other purposes related to his employment or his trade or business.

The tax characterization urged herein by the Commissioner also comports with the public policy and purpose of Section 16(b). The purpose of Section 16(b) was to insure an honest securities market by squeezing out all profits from short-term insider trading. As a result the statute is applied so as to deprive the insider of any benefits received on account of the sale. This policy to disallow any direct or indirect profits, would be fundamentally undermined by the Tax Court's position. Ordinary business expense or loss treatment will effectively give taxpayer a federal subsidiary to assist in the payment of his Section 16(b) liability--a rather anomalous result indeed. For all these reasons the decision of the Tax Court should be reversed.

ARGUMENT

TAXPAYER'S PAYMENT TO MGM MADE PURSUANT TO SECTION 16(b) OF THE SECURITIES AND EXCHANGE ACT OF 1934, WHICH AROSE FROM A SERIES OF TRANSACTIONS IN WHICH TAXPAYER REALIZED LONG TERM CAPITAL GAIN, SHOULD BE TREATED AS A LONG TERM CAPITAL LOSS

This case presents the question of whether a payment made by a corporate director pursuant to Section 16(b) of the Securities Exchange Act of 1934, c. 404, 48 Stat. 881 (15 U.S.C. § 78p), as a result of insider trading, upon which he realized long-term capital gain, should be deductible as an ordinary loss or business expense or as a long-term capital loss. The Tax Court consistently has held that such payments are deductible as ordinary and necessary business expenses and need not assume the character of the gain realized in the suspect transaction. This holding is based on the Tax Court's view that the payments and the stock transactions may not be integrally related, and, when these payments can be viewed as being made by the insider for reasons related to his trade or business, then an ordinary expense deduction may be taken for such payment. Both the Sixth Circuit in Mitchell v. Commissioner, 428 F. 2d 259 (1970), cert. denied, 401 U.S. 909 (1971), and the Seventh Circuit in Anderson v. Commissioner, 480 F. 2d 1304 (1973), have uniformly rejected the Tax Court's approach to this issue and held that since the Section 16(b) payments are integrally related to the underlying insider stock transaction under the Arrowsmith tax

benefit rule (enunciated in Arrowsmith v. Commissioner, 344 U.S. 6 (1952)), a Section 16(b) payment deduction must assume the tax character of the gain that was originally taken into income. See also Rev. Rul. 61-115, 1961-1 Cum. Bull. 46. The Tax Court refused to follow the decisions in Mitchell and Anderson in this case. It did not regard itself bound by those decisions since the proper venue herein lay with this Court, which has not yet considered this issue. We submit that the reasoning of the Sixth and Seventh Circuits in this matter is correct and controlling.

Section 16(b) of the Securities Exchange Act of 1934 provides in pertinent part as follows (Securities Exchange Act of 1934, c. 404, Sec. 16(b), 48 Stat. 881 (15 U.S.C. § 78p):

> For the purpose of preventing the unfair use of information which may have been obtained by * * * [a] director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer * * * within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such * * * director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months.

The purpose of Section 16(b) was to insure a fair and honest securities market by eliminating short-swing insider trading. To effect this purpose, its application was not limited to situations where unfair use of insider information could be proven, but rather relies on objective measures of proof, i.e., whenever

(1) a corporate officer engages in (2) a sale of stock which is followed within six months by (3) his purchase of the stock at a lower price. Bershad v. McDonough, 428 F. 2d 693, 696 (C.A. 7, 1970), cert. denied, 400 U.S. 992 (1971). To optimize its prophylactic effect, strict liability adheres virtually automatically when an insider engages in such short-term transactions, without regard to the insider's intent. Smolowe v. Delendo, 136 F.2d 231, 235-237 (C.A. 2, 1943); R. T. Babbitt, Inc. v. Lachner, 332 F. 2d 255, 258-259 (C.A. 2, 1964); Blau v. Lamb, 363 F. 2d 507 (C.A. 2, 1966); see also Reliance Electric Co. v. Emerson Electric Co., 404 U.S. 418 (1972).

It is undisputed that taxpayer's sales of MGM stock in April, 1961, and his subsequent repurchases of MGM stock in September and November, 1961, fell within the proscribed six month period and that taxpayer was a director of MGM throughout this period. While the Tax Court correctly stated that taxpayer had not been adjudicated as having violated Section 16(b), all of the elements of such a violation were present.[5/] Nor has taxpayer presented any defenses ameliorating his liability or in fact denied its applicability. Even if the Section 16(b) violation resulted from taxpayer's inadvertance, such inadvertance,

5/ Petitioner's Exhibit 8 (R. 26-28), a letter to MGM from its independent counsel relating to taxpayer's request to be reimbursed for the Section 16(b) payment previously made by him, based its advice that such repayment should not be made squarely on the fact that "Mr. Cummings' liability under the Act was indisputable" (R. 27) with the result that "there is no legal basis for repayment" (R. 28).

or mistake, as the cases cited supra indicate, is not a sufficient defense. Accordingly, the Tax Court's findings (R. 83-85)--that a considerable part of taxpayer's willingness to promptly pay over his profits stemmed from his efforts to protect his business reputation, to prevent embarrassment to himself and MGM, and to expedite the distribution of MGM's proxy solicitation materials--do not vitiate the inescapable fact that this payment was made in satisfaction of the alleged Section 16(b) liability. 6/ We submit that such findings are insufficient to overcome the

---

6/ The Tax Court majority went to great lengths to find that the payments constituted ordinary and necessary business expenses. In view of taxpayer's clear Section 16(b) liability this ultimate finding must be viewed with considerable skepticism. The payment fits squarely within Professor Loss' observation (II Loss, Securities Regulation, p. 1043) that: "Since the elements of the action are so simple, the defendant is apt to find that he has no practicable alternative but to pay up." The Tax Court further failed to understand the distinction between the liability itself and the timing of the payment of that liability. Taxpayer's trading in shares of MGM an act which neither enhanced nor deterred his performance as a director nor which was required as a condition of his position, gave rise to the liability. Taxpayer's only business concern in making the payment was not whether he would make it, but whether he would delay the payment, thereby arguably endangering his business reputation and position, or would make the payment promptly thereby avoiding this danger. The fact that business considerations might induce taxpayer to pay promptly rather than delay and pay after litigation cannot permit the deduction as a business expense. Ditmars v. Commissioner, 302 F. 2d 481, 487 (C.A. 2, 1962). Accordingly, while we feel the Tax Court erred in holding that the payments were ordinary and necessary expenses, we will not address a full argument against the holding because Arrowsmith will govern in any event.

overriding legal effect of the tax benefit rules as announced in Arrowsmith v. Commissioner, supra, expanded in United States v. Skelly Oil Co., 394 U.S. 678 (1969), and applied in Mitchell v. Commissioner, supra, and Anderson v. Commissioner, supra.

In Arrowsmith v. Commissioner, 344 U.S. 6 (1952), the Supreme Court enunciated a tax benefit rule to determine the tax characterization of amounts deducted in later years, which were originally included in income under a claim of right in previous years. In Arrowsmith, the taxpayer received payments in 1937 through 1940 in liquidation of a jointly owned corporation and reported these payments as capital gains. In 1944, a judgment was rendered against taxpayer and the corporation. Taxpayer paid the judgment and deducted it as an ordinary business loss. The Supreme Court denied the ordinary business loss characterization and held that the payments should be treated as capital losses even though occurring in later years, because they arose solely from the prior liquidation (344 U.S., p. 8). In United States v. Skelly Oil Co., 394 U.S. 678, 685 (1969), the Supreme Court succinctly paraphrased the Arrowsmith tax benefit rule as follows:

> The rationale for the Arrowsmith rule is easy to see; if money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair windfall if repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income. The Court in Arrowsmith was unwilling to infer that Congress intended such a result.

Accordingly, the Supreme Court held in Skelly Oil that excess charge refunds from prior years could only be deducted from current income to the extent they had been included in past income. Taxpayer had been ordered to refund $505,536.54, but was allowed to deduct only $366,513.99, because 27 percent of the original overcharges had been excluded from income under the 27-1/2 percent oil depletion exemption.

In Mitchell v. Commissioner, supra, p. 263, the Sixth Circuit applied this tax benefit rule to substantially identical facts as those at bar as follows:

> The taxpayer here, as in Skelly Oil, received income which was taxed at reduced rates, thereby receiving a tax benefit. In the present case, as in Skelly Oil, the taxpayer was required to give up a part of that income. Under Arrowsmith and Skelly Oil, when income is given up, which in its inception was taxed at reduced rates, the taxpayer is not permitted to enjoy preferred treatment twice by deducting in full the extra amount given up as an ordinary deduction.

In the case at bar, taxpayer realized capital gain on his stock transactions which he duly reported as capital gain in 1961. (R. 6.) Subsequently in January, 1962, he paid MGM the "profits" he realized on the sales transaction, thereby giving up a portion of the amounts he originally had included on his income as capital gain. To be sure the actual capital gain taxpayer realized on this stock transaction for federal tax purposes is not computed in the same manner as are Section 16(b)

profits,[7/] so that the federal tax and the repayment may not always be the same amount. Nevertheless, Arrowsmith and Skelly Oil still adhere. It is of no substantial moment that the original capital gain or loss differs from Section 16(b) profit. Considering that the later repayment merely reduces the consideration originally received on the stock sale, the tax gain is properly recomputed simply by effectively decreasing the amount of the original capital gain or increasing the amount of the original capital loss. Commissioner v. Adam, Meldrum & Anderson, 215 F. 2d 163, 166 (C.A. 2, 1954); Millikin v. Commissioner, 196 F. 2d 135, 139 (C.A. 2, 1952), cert. denied, 344 U.S. 884 (1952), rehearing denied, 344 U.S. 910 (1952).

Similarly, in Anderson v. Commissioner, supra, p. 1307, the Seventh Circuit characterized these payments as representing "a portion of the sales proceeds, and adjustment on the sale price." Such a characterization most aptly takes into account the nature of the Section 16(b) payment and its relationship to the profit realized on the stock sale. Despite the authority to the contrary, the Tax Court declined to apply the Arrowsmith

7/ "Profits" for Section 16(b) purposes are computed by pairing the shares sold at the highest price against the shares purchased at the lowest price and the process continues in descending order until enough shares to equal the total number of shares both bought and sold are paired. Then the profit is determined by adding the totals obtained by subtracting the purchase price from the sale price of all the pairings. Smolowe v. Delendo Corp., supra, p. 239.

doctrine to the case at bar, buttoned on the erroneous theory that the Section 16(b) payment is not directly or integrally related to the earlier sales transaction stock sale which gave rise to the capital gain. (R. 82, 97.) Both the Mitchell and Anderson courts rejected such a narrow view as to the integral and direct relationship of the triggering sale transaction and the subsequent Section 16(b) payment. In Anderson, the Court stated (p. 1307) that--

> Bifurcating the sale and payments smacks of artificiality, and characterizing the sale-purchase occurrence as without tax significance could only have been done in a vacuum.

As the dissenting Tax Court opinion in Anderson v. Commissioner, 56 T.C. 1370, 1377-1379, noted, the Section 16(b) payments were inextricably entertwined with taxpayer's stock transactions.[8/] Such a conclusion follows implicitly from the operation of Section 16(b). The absolute and automatic application of Section 16(b) is triggered by the repurchase of stock within the proscribed period, and requires the repayment of the profits realized in the prior stock sale. In both Arrowsmith and Skelly Oil, the respective transactions resulting in the gain or income therein were standing alone, closed and completed for tax purposes, yet in each case later events required the repayment of portions of the amounts taken into income. See also,

---

8/ The dissent of one of the judges below was based upon the reasoning expressed in the dissent in Anderson. (R. 101.)

Milliken v. Commissioner, supra, p. 137. This reasoning applies equally well to the situation herein, where taxpayer correctly took into income the capital gain realized on his stock sales, subject to forfeiture of those gains if he repurchased stock within the proscribed six-month period. Accordingly, the Tax Court's consistent[9] view that the payment and the initial sale are not integrally and directly related is erroneous and unfounded.

The Tax Court took exception to this reasoning by holding (R. 83, 99) that Arrowsmith and its progeny only applied when the taxpayer received the income in the same capacity as he repaid it. The Tax Court determined that the sale transaction was conducted in taxpayer's capacity as a shareholder and that the Section 16(b) payment was made in his capacity as a director. The court in Anderson specifically rejected (p. 1308) a similar employee-shareholder distinction on the ground that nothing in Arrowsmith or Skelly Oil requires that the purpose of the taxpayer in satisfying the demand must be rooted exclusively in the identical capacity in which the profit was realized and the demand for payment made. As the Seventh Circuit there explicitly pointed out (p. 1308), taxpayer sold his stock as an insider or shareholder-employee. Section 16(b) only applies to insider

9/ In each of the three cases dealing with this issue, the entire Tax Court has reviewed the decisions and has maintained this view in the respective majority opinions. However, the Tax Court is becoming increasingly split on this issue as illustrated by the dissent of two judges in Anderson and six in the case at bar.

shareholders. As long as taxpayer here was a director of MGM, all of his sales and purchases of its stock were subject to the six-month proscription of Section 16(b). As the Court held in Adler v. Klawans, 267 F. 2d 840, 846 (C.A. 2, 1959) "nobody is obliged to become a director * * * but, as soon as he does so, he accepts whatever are the limitations, obligations and conditions attached to that position." Similarly, the payment to MGM was made under the color of Section 16(b), which only applies to stock transactions by insiders. No payment would have been made if taxpayer were merely a director owning no stock or if he were a mere shareholder, not qualifying as an insider, selling short term. The payment was made by taxpayer precisely because he was a director whose stock transactions but within the terms set out in Section 16(b).

In support of its position the Tax Court erroneously relied (R. 98) upon United States v. Generes, 405 U.S. 93 (1952), in which the Court was faced with developing a standard for distinguishing between business and non-business bad debt losses, in the light of a Congressional mandate (Section 166 of the Internal Revenue Code of 1954 (26 U.S.C.)) to determine tax treatment on the basis of motivation and status. Here we are dealing with the tax benefit principle whose underlying premises--to deny taxpayers the equivalent of double deductions and to avoid unfair tax windfalls (Skelly Oil, supra, p. 680,

685)--have little if anything to do with the status or motivation of the taxpayer in paying the money, so long as the demand for payment directly relates to the transaction in which he originally realized the income. Nor can Skelly Oil and Arrowsmith be distinguished on the ground that in those cases the payments were returned to the persons from whom the taxpayer had received them, and herein taxpayer repaid his gains to MGM and not the purchaser of his stock. The critical factor is that taxpayer had to give up or disgorge part of his gains, and it makes no rational difference whether that repayment is to the purchaser, MGM or the Securities Exchange Commission. Nor, we submit, would the Skelly Oil rationale have been altered if the overcharges had been paid to the regulatory commission, rather than refunded to the customers. In all events, the payment remains an adjustment to taxpayer's stock sale profits.

Accordingly, the Tax Court's preoccupation with taxpayer's business purpose in promptly paying the Section 16(b) demand to cases focuses upon an irrelevancy. Whatever taxpayer's motivation, was for the timing of his payment of amount, that action can not alter the nature of the payment. The liability for this payment arose solely because he engaged in short-swing transactions proscribed by Section 16(b). While business and personal reasons may have led taxpayer to pay this liability promptly, rather than to defer payment and litigate, it cannot transform the nature of this liability. It is the nature and

origin of the underlying claim that controls, not the timing of the payment nor the purpose for making payments at that time rather than taking other courses of action. United States v. Gilmore, 372 U.S. 39, 49 (1963); Woodward v. Commissioner, 397 U.S. 572, 577 (1970); Spangler v. Commissioner, 323 F. 2d 913, 916-917 (C.A. 9, 1963).

The tax treatment presented herein also comports significantly with the purpose and policy consideration of Section 16(b). While the tax law is not directed to implement Section 16(b), it is equally clear that the tax law should not be implemented to frustrate the purpose and operation of Section 16(b), Anderson v. Commissioner, supra, pp. 1307-1308. As this Court stated in the leading case of Smolowe v. Delendo Corp., supra. pp. 239:

> * * * the statute [Section 16(b)] was intended to be thoroughgoing, to squeeze all possible profits out of stock transactions, and thus to establish a standard so high as to prevent any conflict between the selfish interest of a fiduciary officer, director or stockholder and the faithful performance of his duty.

See also Reliance Electric Co. v. Emerson Electric Co., 404 U.S. 418, 423 (1972). Given the stringent application of Section 16(b) to squeeze out all profit from insiders' short-swing stock sales, it would be anomalous to permit the insider to profit indirectly by operation of the tax laws.[10/] See Anderson

10/ Prior to 1961, the Commissioner took the position that a Section 16(b) payment was not deductible at all, viewing it as punitive and, consequently, denying deductibility on public policy grounds. Recognizing that the Section 16(b) payment is remedial, the Commissioner now takes the position, consistent with the purpose of Section 16(b), that the payment is deductible only as a capital loss to the extent the gain realized on the sale was reportable as capital and not ordinary income. See

v. Commissioner, supra, p. 1308. The allowance of a deduction against income taxable at ordinary rates for the amount previously taxed at the preferential tax rates effectively operates as a Government subsidy of a Section 16(b) liability. Such a result would clearly contravene the purpose of Section 16(b) to squeeze out all insider profits. Allowance of the payment here in issue as a long-term capital loss in 1962 will approximate the tax benefit conferred in the prior year by offsetting the prior capital gain and not reducing taxpayer's 1962 ordinary income. That capital loss deduction will render the tax law as neutral as can be accomplished when applied to transactions falling within Section 16(b), neither giving an insider an unintended profit nor adding an additional penalty to Section 16(b).11/

10/ (continued)
Rev. Rul. 61-115, 1961-1 Cum, Bull. 46. In short, the Commissioner now feels that while it would be inappropriate to deny deductibility altogether, thereby increasing the impact of Section 16(b), it would be equally inappropriate to permit an ordinary deduction which would effectively decrease the impact of Section 16(b).

11/ The neutrality that the Commissioner's position would accomplish vis-a-vis Section 16(b) is tempered somewhat by the rigors of the annual accounting system. Thus, where the sale and repayment occur in different years, there is a possibility that the benefit of the capital loss deduction will not equal the detriment of the inclusions in the year of sale, i.e., if tax rates have changed and taxpayer is in a different bracket. This does not mean that reference to the treatment of the sale is inappropriate for, as the Court noted in Arrowsmith, any inequity that this might generate is an inevitable feature of our annual accounting system. Section 1341, Internal Revenue Code of 1954, may also mitigate this inequity to a large extent. See United States v. Skelly Oil Co., 394 U.S. 678, 680-681 (1969).

CONCLUSION

For the reasons stated above, the decision of the Tax Court should be reversed.

Respectfully submitted,

SCOTT P. CRAMPTON,
Assistant Attorney General,

MEYER ROTHWACKS,
RICHARD W. PERKINS,
LOUIS A. BRADBURY,
Attorneys,
Tax Division,
Department of Justice,
Washington, D.C. 20530.

MAY, 1974.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this 8th day of ~~April~~ May, 1974, in an envelope, with postage prepaid, properly addressed to him as follows:

Glen H. Kanwit, Esquire
Hopkins, Sutter, Owen, Mulroy
and Davis
One First National Plaza
Chicago, Illinois 60670

Meyer Rothwacks/euh
MEYER ROTHWACKS,
Attorney.